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Small Business Tax Relief: Selected Economic Policy Issues for the 107th Congress

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Summary

A perennial concern of Congress is the federal tax burden on small firms and its implications for their performance and growth. A clear manifestation of this concern is the many bills introduced in the 106th Congress and so far in the 107th Congress to expand current small business tax preferences. Although the exact federal revenue cost of these preferences is unknown, estimates by the Joint Committee on Taxation suggest that it probably will exceed $6 billion in fiscal year 2001, not including the reduced tax burden on unincorporated firms. The non-agricultural small business tax preferences with the broadest impact are the taxation of small firms not organized as corporations, the graduated rate structure for the corporate income tax, the expensing allowance for equipment under section 179 of the Internal Revenue Code, the exemption of some small corporations from the corporate alternative minimum tax, cash basis accounting, and the exclusion from taxation of capital gains on certain small business stock.

Proposals to expand small business tax preferences or subsidies raise some interesting and important policy issues. For public finance economists, a key issue is whether or not they can be justified on economic grounds. They argue that in the absence of such a rationale, these proposals may adversely affect efficiency or equity.

In general, proponents of enhancing small business tax subsidies cite the special economic role played by small firms and the barriers to their formation and growth as the main economic justifications for such a step. More specifically, they assert that the national income, jobs, technological innovations, and opportunities for economic renewal and structural change provided by small firms; the constraints on their ability to raise capital in debt and equity markets; and the formidable competitive advantages held by large, established firms offer compelling reasons to grant special tax benefits to small firms.

While acknowledging the significant contributions made by small firms to the economy, critics of proposals to expand small business tax subsidies argue that there appears to be no standard economic rationale for doing so. More specifically, they note that these subsidies lessen the progressivity of the federal individual income tax system by reducing the tax burden on owners of small firms and result in no obvious and indisputable efficiency gains. Moreover, critics assert that even if a compelling economic rationale for the subsidies could be found, many current subsidies appear either inappropriate or poorly designed.

The analysis presented here underscores the need for a robust economic model of the formation of small firms and their contributions to the performance and growth of the economy. The development and empirical testing of such a model could help determine whether the formation or growth of small firms is hampered by one or more market failures, and if so, identify the key factors behind these failures and illuminate possible policy interventions.

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A perennial concern of Congress is the federal tax burden on small firms and its implications for their performance and growth. In the 106th Congress, numerous bills were considered that sought to lessen this burden by enhancing current small business tax subsidies or preferences, creating new ones, or reducing the administrative burden imposed on small firms by the requirements of federal tax law. Although none of these proposals was enacted, many attracted strong bipartisan support in both the House and Senate. Similar proposals have been quick to resurface in the 107th Congress.

Proposals to strengthen or expand small business tax subsidies raise some interesting and important policy issues. Considerable resources are transferred to small firms through the federal tax code. For public finance economists, a key issue is whether or not they are justified on economic grounds. They maintain that in the absence of such a rationale, these proposals could adversely affect efficiency or equity.

This report explores this issue by examining the economic arguments for and against small business tax subsidies. It begins with a brief description of current federal tax subsidies for small firms and legislative proposals in the 107th Congress to expand them, moves on to a comparison of the principal economic arguments for and against these subsidies, and concludes with an evaluation of the merits of each set of arguments.

Current Federal Tax Benefits for Small Business

The federal tax code contains a variety of provisions that treat small firms more favorably than large firms.[1] Most of these provisions, which have accumulated over a number of decades, encompass tax deductions, tax exclusions and exemptions, tax credits, tax deferrals, and preferential tax rates. Others endeavor to assist small firms by alleviating the administrative burden of complying with the federal tax code. With the exception of the latter provisions, the common thread running through them is a reduction in a small firm's marginal effective income tax rate relative to that for a large firm.

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[1]See CRS Report RL30827, *Federal Tax Benefits for Small Businesses: A Brief Overview,* by Gary Guenther, (Feb. 1, 2001), 13 p.

The small business tax subsidies with the broadest and largest impact outside agriculture are described below. Excluded from the list are subsidies targeted at small firms in specific industries, such as life insurance, banking, and energy production or distribution. While available information is insufficient to disclose the total budgetary cost of these subsidies, recent estimates by the Joint Committee on Taxation (JCT) suggest that it probably will exceed $6.0 billion in fiscal year (FY) 2001.[2] This estimate does not take into account any revenue gains or losses arising from changes in the level or composition of overall business investment induced by small business tax preferences.

Taxation of Passthrough Entities

Business enterprises operate in various legal organizational forms. For tax purposes, the predominant ones are subchapter C corporations, subchapter S corporations, sole proprietorships, partnerships, and limited liability companies. The earnings of C corporations are taxed twice: once at the entity level and again at the individual level when the earnings are distributed to owners (i.e., shareholders) in the form of dividends or realized capital gains. By contrast, the earnings of the other business entities are taxed only once: at the individual level of their owners. This latter cluster of firms is often referred to as passthrough entities.

Although there is no legal requirement that corporations be large in income, asset or employment size, and that passthrough firms be small, in practice, such a dichotomy appears to prevail. In 1997, for example, the average C corporation's asset value was 146 times greater than that of the average partnership and 23 times greater than that of the average S corporation.[3]

Whether the owners of a firm are better off operating as a C corporation or as a passthrough entity depends on a host of tax and non-tax considerations. The primary tax considerations are the tax rates for corporate and personal income and capital gains, the investment horizon of owners, the holding period for corporate stock, and the rate at which corporate profits are paid out as dividends.

For high-income investors, the current mix of these tax rates appears to favor passthrough entities by a small margin. As of July 1, 2001, the top personal tax rate is 38.6%, most corporate profits are taxed at 35%, and the top tax rate on long-term capital gains is 20%.[4] Assuming an investment horizon of one year, tax considerations alone would dictate that individuals in the highest individual tax bracket prefer the partnership form to the corporate form. This is because the annual

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[2]See U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, 106th Cong., 2nd sess. (Washington: GPO, 2000).

[3]Internal Revenue Service, *Statistics of Income Bulletin: Spring 2000* (Washington: 2000), pp. 70, 227, and 229.

[4]As a result of the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the top individual income tax rate dropped from 39.6% to 38.6% on July 1, 2001 and is scheduled to remain at that level through the end of 2003.

pre-tax return to a partnership would be taxed at a marginal tax rate of 38.6%, whereas the marginal tax rate faced by a corporation would be 48%.[5] Similarly, if the investment horizon were extended to five years, all after-tax income earned during that period were reinvested in the business, and individuals in the top tax bracket were to earn average annual pre-tax rates of return of 20% on investments in both partnerships and corporations, then tax considerations still would favor the partnership form, because partnerships would yield a higher after-tax rate of return than corporations: 12.2% versus 10.8%.[6]

Nonetheless, it is important to keep in mind that these tax advantages do not constitute a small business tax benefit. Firms that are large in employment, revenue, or asset size are permitted to operate as S corporations or LLCs. In addition, sharp cuts in the top corporate and long-term capital gains tax rates relative to the maximum individual income tax rate could give C corporations an edge over passthrough entities.

Graduated Corporate Income Tax Rates

Corporations with less than $10 million in taxable income are subject to graduated federal income tax rates. The rate is 15% on the first $50,000 of income, 25% on the next $25,000, and 34% thereafter. The benefit of these reduced rates is eliminated for corporations with taxable income above $335,000, who pay a flat average rate of 34%. Corporations with taxable incomes in excess of $10 million pay a marginal rate of 35%. Furthermore, marginal rates are higher in the phaseout ranges. For instance, a corporation with taxable income between $100,000 and $335,000 is subject to a marginal rate of 39%, which is 5% greater than the marginal rate on taxable incomes just above and just below that range.[7]

This graduated rate structure tends to benefit corporations that are small in employment or asset size, since their taxable income is likely to remain below the $335,000 threshold. And it gives owners of closely held firms an incentive to incorporate as a way of sheltering income from higher individual tax rates. Not all small corporations, however, are allowed to take advantage of the reduced rates available under this structure. Specifically, the taxable income of corporations that provide services in the fields of health care, law, engineering, architecture, accounting, actuarial science, the performing arts, and consulting is taxed at a flat rate of 35%.

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[5]These tax rates are derived from the following formula: (1- *tp*) # (1- *tc*) x (1- *tcg*), where *tp* is the highest personal tax rate, *tc* is the highest corporate tax rate, and *tcg* is the maximum tax rate on long-term capital gains. See Myron S. Scholes, et. al., *Taxes and Business Strategy: A Planning Approach*, 2nd edition ,Upper Saddle River, NJ: Prentice-Hall, Inc., 2001), p. 67.

[6]The after-tax rate of return for a partnership is derived from the following formula: $1[1 + *R* x (1- *tp*)]^n, where *R* is the expected pre-tax rate of return, *tp* is the highest personal tax rate, and *n* is the investment horizon. The after-tax rate of return for a corporation is derived from the following formula: $1[1 + *R* x (1- *tc*)]^n (1- *tcg*) + *(tcg* x $1), where *R* and *n* are the same as the previous formula, *tc* is the highest corporate tax rate, and *tcg* is the maximum tax rate on long-term capital gains. See Myron S. Scholes, *Taxes and Business Strategy*. p. 66.

[7]Senate Committee on the Budget, *Tax Expenditures*, p. 258.

The revenue loss associated with the reduced rates on the first $10 million of corporate taxable income is expected to total $4.3 billion in FY 2001.[8]

Expensing Allowance for Certain Depreciable Business Assets

Expensing is the treatment of a business cost as an ordinary and necessary expense rather than as a capital expenditure. Ordinary and necessary costs are deducted in the year in which they are incurred, whereas capital costs are recovered over longer periods as specified in current depreciation schedules. Under section 179 of the Internal Revenue Code (IRC), firms may expense up to $20,000 of the cost of qualified business property – mainly equipment – and depreciate the remainder (if any) under current cost recovery rules. This expensing allowance is scheduled to rise to $25,000 in 2003 and thereafter. But because of a phaseout rule, not all firms purchasing qualified property are able to take advantage of the allowance. It is phased out (ultimately to zero), dollar for dollar, once spending on qualified property exceeds $200,000 in a given tax year.

The allowance is a tax subsidy because expensing effectively taxes the returns on investments in qualified property at a rate of zero, and it constitutes a small business tax subsidy because the phase-out rule means that firms spending over $220,000 on this property in 2001 – which are likely to be large in asset, employment, and revenue size – cannot claim the allowance. In FY 2001, the allowance is expected to lead to a revenue loss of $1.5 billion.[9]

Exemption of Certain Small Corporations From the Corporate Alternative Minimum Tax

Under current federal tax law, corporations must compute their income tax liability under both the regular tax and the alternative minimum tax (AMT) and pay whichever is greater. Each tax has its own rates, permissible deductions, and rules for the measurement of income. In general, the AMT applies a lower marginal rate to a broader tax base. Since 1998, corporations with average annual gross receipts of $5 million or less in the three previous tax years have been exempt from the AMT. This exemption may give some small corporations a competitive advantage over larger corporations who pay the AMT. There is some evidence that firms that invest heavily in equipment and intangible assets like research and development (R&D), finance the bulk of their investments through debt, and pay the AMT for five or more successive years have a higher cost of capital than firms that pay only the regular income tax.[10] If anything, the exemption gives owners of small firms an incentive to incorporate, as the taxable income of owners of passthrough entities is subject to the individual AMT as well as the regular individual income tax.

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[8] *Ibid*., p. 257.

[9] *Ibid*., p. 249.

[10] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington: Brookings Institution, 1997), pp. 77-97.

Cash Basis Accounting

Two methods of financial accounting enjoy widespread use in the private sector: cash basis and accrual basis. Under cash basis accounting, which is the preferred choice for most self-employed individuals, income generally is recorded when it is received in the form of cash or its equivalent, and expenses generally are recorded when cash is paid, regardless of when the income is actually earned or the expenses actually incurred. Under accrual basis accounting, by contrast, income and expenses generally are recorded when the transactions that give rise to them are completed or nearly completed, regardless of when cash or its equivalent is received or paid. Cash basis accounting is much simpler to administer, but accrual basis accounting tends to yield a more accurate measure of a firm's economic income.

Current federal tax law specifies that certain firms must use the accrual method in computing their taxable income: namely, firms that are required to maintain inventories, C corporations with average annual gross receipts above $5 million in the last three tax years, partnerships with C corporations as partners, trusts that earn unrelated business income, and authorized tax shelters. All other firms, including C corporations with $5 million or less in average annual gross receipts in the previous three tax years, may use the cash method with the approval of the Internal Revenue Service. In reality, many of the firms permitted to use the cash method are small in income, asset, or employment size.

Cash basis accounting can result in a small business tax subsidy similar to that provided by the expensing allowance: the deferral of income tax payments. In principle, a firm earns income when the legal obligation to be paid is first established. Under the cash method of accounting, however, a firm may delay the recognition of income until cash payments are received, thereby postponing the payment of tax on that income. The JCT estimates that the use of cash accounting outside agriculture could cost the U.S. Treasury about $0.1 billion in forgone tax revenue in FY 2001.[11]

Exclusion of Gains on Certain Small Business Stock

Under IRC section 1202, long-term capital gains on the sale or exchange of certain small business stock are taxed at a maximum effective rate of 14%. This is lower than the maximum long-term capital gains tax rates of 20% on the sale or exchange of stock held longer than one year and 18% on the sale or exchange of stock held more than five years. The preferential capital gains tax rate for small business stock results from excluding 50% of the gain from taxation, leaving the remaining gain to be taxed at a maximum rate of 28%. For individuals subject to the AMT, 42% of the excluded gain is treated as an individual AMT preference item. To qualify for the exclusion, the stock must be held more than five years, must have been issued after August 10, 1993 by a C corporation that had gross assets valued at $50 million or less when the stock was issued and that uses 80% or more of its assets in the active conduct of a trade or business (with some exceptions), and must have been acquired by individual taxpayers at its original issue in exchange for money or property or as payment for services rendered to the issuing corporation. The capital

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[11]Senate Committee on the Budget, *Tax Expenditures*, p. 275.

gain eligible for the exclusion is limited to the greater of $10 million or 10 times the taxpayer's cost of acquiring the stock (or his or her basis in it).

The exclusion represents a small business tax benefit because it gives investors a tax incentive to purchase and hold the stocks of eligible small firms that may otherwise have difficulty attracting equity capital.

Magnitude of Small Business Tax Benefits

This discussion makes it clear that aspects of current federal tax law favor investment in small firms. It also raises the question of to what extent owners of small firms can be said to enjoy tax advantages over owners of large firms.

One approach to answering this question lies in comparing the marginal effective tax rates for assets owned by incorporated and unincorporated firms. These rates show the percentages of pre-tax returns on investments in these assets that are paid in income taxes, which are a measure of the tax burden on new business investment. Such a comparison is likely to shed some light on the tax advantages of small business owners for the following reason: most large firms are incorporated, whereas the overwhelming majority of unincorporated firms are small in employment, asset, or receipt size. If the tax code favors investment in small firms, the marginal effective tax rates for assets owned by unincorporated firms should be lower than those for assets owned by corporations.

Table 1. Marginal Effective Tax Rates for Equity-Financed Investment in Corporate and Noncorporate Business Enterprises

Type of Asset	Corporate (Large)	Noncorporate
Equipment	43%	24%
Structures	51%	28%
Inventory	53%	35%
Total	47%	28%

Source: Jane Gravelle, Congressional Research Service.

Note: The calculations assume that an investor is in the 28% tax bracket, the rate of inflation is a 3%, the real discount rate is 5%, the dividend payout rate is 60%, and half of capital gains on corporate stock are realized in a 5-year holding period.

Table 1 shows the marginal effective tax rates under current tax law for a variety of tangible assets held by incorporated and unincorporated firms. The estimates were generated by CRS. They suggest that the tax burden on small firms is substantially lower than the tax burden on large firms. The main reason for this disparity is the exemption of S corporation, partnership, LLC, and sole proprietorship taxable

incomes from the corporate income tax. Moreover, if the estimates were to take into account other tax provisions that benefit small firms more than large firms (e.g., the expensing allowance), the apparent tax advantage of small business owners would be even greater.

Recent Congressional Initiatives to Enhance or Expand Current Small Business Tax Subsidies

Underscoring the popularity and political influence of small businesses, a host of legislative initiatives to enhance or expand existing small business tax subsidies was introduced in the 106th Congress. At least 39 bills – in whole or in part – had such a purpose.[12] The bills varied in scope from something as minor and limited as allowing a tax deduction for year-2000 computer software conversion costs incurred by small firms (e.g., H.R. 179 and S. 962) to something as major and open-ended as granting tax credits to small firms that provide new qualified health or pension plans for their employees (e.g., H.R. 352, H.R. 1021, H.R. 5184, S. 487, S. 1863, S. 2964, and S. 2994.) Many of the 39 bills sought to enhance current small business tax benefits, such as the IRC section 179 expensing allowance (e.g., H.R. 2087, H.R. 2574, H.R. 3832, S. 1341, and S. 1867), the use of cash basis accounting outside agriculture (e.g., H.R. 2273 and S. 2246), and the 50% exclusion of gains on certain small business stock (e.g., H.R. 1084, H.R. 2331, and S. 3096).

Arguably, the most notable legislative initiatives in the 106th Congress were the ones passed by one or both houses.[13] The first such measure was the Taxpayer Refund and Relief Act of 1999 (H.R. 2488), which Congress passed in August 1999 and President Clinton vetoed the following month. Among its many provisions, H.R. 2488 offered some tax benefits to small firms, the most broadly based of which was an increase in the section 179 expensing allowance to $30,000 as of January 1, 2000. In addition, the House and Senate combined passed three measures to raise the hourly minimum wage, each of which included provisions enhancing, clarifying, or expanding existing small business tax benefits; none won the approval of both houses. The first such action happened in February 2000, when the Senate passed an amended version of H.R. 833 which included an increase in the expensing allowance to $30,000 as of January 1, 2001 and a gradual increase in the deductible share of the cost of business meals for employees of small firms from 50% to 80%. Then, in March 2000, the House approved a version of H.R. 3081 which also included an increase in the expensing allowance to $30,000 as of January 1, 2001. Finally, in October 2000, the House adopted the Taxpayer Relief Act of 2000 (H.R. 5542) as part of the conference report for H.R. 2614; among other things, H.R. 5542 would have raised the expensing allowance to $35,000 on January 1, 2001 and permitted certain small firms that are

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[12]This total excludes bills that would have boosted tax benefits for small firms in particular industries such as property and casualty insurance or small firms investing in specific geographic regions such as federally designated empowerment zones.

[13]For a review of important tax legislation in the 106th Congress, see CRS Issue Brief IB10013, *Major Tax Issues in the 106th Congress: A Summary*, by David L. Brumbaugh, (December 19, 2000).

required under current federal tax law to use the accrual method of accounting to use the cash method of accounting for tax purposes.

Similar proposals have been quick to resurface in the 107th Congress. The most notable so far from the standpoint of legislative action is the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836, P.L. 107-16), which the House and Senate approved on May 26, 2001 and President Bush signed into law on June 7, 2001.[14] Among other things, it implements a modified version of the reductions in individual income tax rates advocated by President Bush during the 2000 presidential election campaign and contained in a proposal he sent to Congress on February 8, 2001. The act establishes a new 10% tax bracket for a portion of taxable income that is currently taxed at 15% ; retains the 15% bracket; and, between July 1, 2001 and January 1, 2006, gradually reduces the 28% bracket to 25%, the 31% bracket to 28%, the 36% bracket to 33%, and the 39.6% bracket to 35%.

These changes have at least two important implications for small business. First, they shrink the tax burden on the owners of small firms organized as passthrough entities. Second, they increase the income tax advantage of operating a small firm as a passthrough entity rather than a corporation.[15] The first effect may outweigh the second in the long run. There is reason to think that reducing the tax burden on the owners of small passthrough entities such as sole proprietorships could accelerate growth in small business output.[16]

Other bills introduced so far would add or enhance certain broadly based small business tax preferences. They are summarized below by type of preference. Some of these proposals may be considered later in the year by the full House or Senate as part of a legislative initiative to increase the federal minimum wage.[17]

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[14]For more details on the history of the bill and its provisions, see U.S. Library of Congress, Congressional Research Service, *Major Tax Issues in the 107th Congress*, by David L. Brumbaugh, CRS issue brief IB10068, (Washington: continually updated).

[15] President Bush proposed lowering the top individual tax rate from 39.6% to 33% between 2001 and 2006. The Treasury Department's Office of Tax Analysis estimated that 800,000 small business owners and entrepreneurs would benefit from this cut. It also estimated that these same individuals would receive 77% of the tax relief provided by this reduction. See Patti Mohr, "O'Neill Gives Small Businesses Reassuring Tax Cut Prognosis," *Tax Notes*, vol. 91, no. 7, May 14, 2001, pp. 1053-1055.

[16]In a recent analysis of the impact of personal income tax rates on the growth of small firms using tax return data from just before and just after the Tax Reform Act of 1986 took effect, Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen found that when a sole proprietor's marginal tax rate rose by 10 percent, his business receipts went up 8.4%. This implied that a reduction in the marginal tax rate levied on a sole proprietor from 50% to 33% would lead to a 28-percent increase in his or her receipts. See Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, *Personal Income Taxes and the Growth of Small Firms*, Working Paper 7980, National Bureau of Economic Research (Cambridge, MA: Oct. 2000).

[17]Katherine M. Stimmel and Elizabeth White, "Baucus Says Markup of Tax Breaks Linked With Minimum Wage Hike Will Wait Until Fall," *Daily Report for Executives* (Washington:

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IRC Section 179 Expensing Allowance

Some bills would make the expensing allowance available under IRC section 179 more generous. Specifically, H.R. 546 would increase the maximum amount that can be expensed to $30,000 as of January 1, 2001, and H.R. 1018 would do likewise as of January 1, 2003. Furthermore, several bills would raise the expensing allowance and the threshold at which the allowance begins to phase out, and adjust both amounts for future inflation: H.R. 657, H.R. 1057, S. 189, and S. 236. Finally, the same bills would expand the range of property eligible to be expensed to include commercial computer software. In addition, H.R. 657 would make residential rental property eligible for expensing.

Cash Method of Accounting

Several bills would clarify the rules governing which firms may use the cash method of accounting and avoid the accrual method of accounting for tax purposes. Their principal direct effect would be to expand the range of small firms eligible to use the cash method – and thus benefit from whatever tax deferrals may result. Specifically, H.R. 656, H.R. 1037, S. 189, and S. 336 would allow firms with average annual gross receipts of $5 million or less in the three previous tax years beginning in 2001 to use the cash method of accounting even if they maintain inventories as part of their normal business operations. The same bills would adjust this gross receipts test for future inflation.

Exemption of Small Corporations from the AMT

Three bills, H.R. 1037, S. 189, and S. 616, would phase out the individual AMT during 2001 to 2005 and expand the number of small firms that are exempt from the corporate AMT. In each case, the gross receipts test that a small corporation must satisfy in order to qualify for the exemption would go up from an average of $7.5 million for the three previous tax years under current law to an average of $10 million, and from an average of $5 million for the first three tax years under current law to an average of $7.5 million, effective January 1, 2001.

Exclusion of Gains on Certain Small Business Stock

A Senate bill (S. 455) would alter IRC section 1202 to expand the partial exclusion of long-term capital gains on the sale or exchange of small business stock. It would increase the share of gains that can be excluded from 50% to 75% and reduce the maximum long-term capital gains tax rate on the remaining 25% of gains from 28% to 20%. The bill would also shrink the required holding period for small business stock eligible for the exclusion from five years to three years, repeal the current requirement that 42% of any excluded gain be treated as an individual AMT preference item, relax the existing restrictions on working capital held by qualified

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[17](...continued)
Bureau of National Affairs), July 11, 2001, p. G-12.

small firms, and expand the range of business activities eligible for the exclusion to include computer software, biotechnology, and aquaculture.

Increased Deduction for the Meal and Entertainment Expenses of Small Firms

Under current law, firms generally are not permitted to deduct more than 50% of their qualified expenses for meals and entertainment. A House bill (H.R. 1555) would permit small firms to deduct 60% of their meal and entertainment expenses in 2001, 65% in 2002 and 2003, 70% in 2004 and 2005, 75% in 2006 and 2007, and 80% in 2008 and thereafter. The proposal defines a small firm as a C or S corporation, partnership, or sole proprietorship whose average annual gross receipts in the previous three tax years is $7.5 million or less for firms older than three years, and $5.0 million or less for firms in the first three years of existence.

Expanded Eligibility for S Corporation Status

Two bills (H.R. 1263 and S. 936) would expand the range of firms eligible to become S corporations and thus avoid paying the corporate income tax. Among other things, each measure would exclude certain investment income from the definition of passive income for an S corporation bank, increase from 75 to 150 the maximum number of shareholders an S corporation may have, allow family limited partnerships and trusts that are individual retirement accounts to become S corporation shareholders, allow a bank director to own stock in an S corporation without the stock being considered a disqualifying second class of stock, and reduce from 100% to 90% the proportion of shares required for shareholders to choose S corporation status.

Tax Credit for Training Expenses for Certain Highly Skilled Trades

Two House bills (H.R. 877 and H.R. 1037) would create a new tax preference for small firms: a $15,000 nonrefundable tax credit for each employee receiving at least 1,500 hours of qualified training in a variety of "highly skilled trades." The trades include mold and die makers, precision machinists, plumbers, and tool and die designers. Firms that employ an average of 250 or fewer workers in a given tax year would be eligible for the credit.

Tax Credit for Small Firms That Offer Health Insurance to Employees

Still another bill (S. 674) would establish a nonrefundable tax credit for small employers that offer health benefits to employees. Specifically, for firms with fewer than 10 employees, it would establish a tax credit equal to 50% of employer contributions toward the cost of qualified employee health insurance; and for firms with 10 to 25 employees, the credit would equal 30% of contributions. For each employee, the amount of expenses eligible for the credit would be limited to $2,000 for individual coverage and $4,000 for family coverage.

Economic Arguments For and Against Small Business Tax Subsidies

Current small business tax preferences and congressional initiatives to expand them pursue a variety of policy goals. Among the noteworthy goals are simplified tax accounting for small firms, improved access to long-term equity capital for small firms, reduced tax burdens on the returns to small business ownership, expansion of the proportion of Americans covered by health insurance, and increases in the supply of skilled labor in certain industries. But regardless of this diversity in aims, current and proposed small business tax subsidies find common ground in the preferential tax treatment they confer on small business.

Proposals to expand existing small business tax subsidies raise a number of interesting and important policy issues. For public finance economists, a key issue is whether or not such proposals can be justified on economic grounds? Another way to frame the issue is to inquire whether a cogent argument based on principles of economic equity or efficiency can be made in favor of small business tax subsidies. The answer has important implications for social welfare, as billions of dollars are transferred to small firms through federal tax expenditures. If the economic rationale for these tax subsidies turns out to be weak or non-existent, then it can be argued that other uses of these resources could lead to higher levels of economic output or a more equitable distribution of the benefits of that output. Of course small business tax subsidies can be supported on other grounds, and these considerations may loom as large as or larger than their efficiency and equity effects in the minds of policymakers evaluating proposals to expand them. But the central focus of this report is the economic arguments for and against such proposals and their relative merits. These arguments are explored in this section.

Key Economic Arguments in Favor of the Subsidies

In general, proponents of small business tax subsidies cite the special economic role played by small firms and the barriers to their formation and growth as the primary economic justifications for the subsidies. More specifically, they point to the national income, jobs, efficiency gains, technological innovations, and structural changes generated by small firms; the opportunities small firms create for women, minorities, and immigrants to enter the mainstream of American life, and the constraints on their ability to raise capital in equity and debt markets as compelling reasons to foster the formation and growth of small firms through tax subsidies.

Elements of this line of reasoning often surface in congressional debates on proposed small business tax subsidies. For example, in introducing legislation in the 106th Congress to modify IRC section 1202, Senator Susan Collins stated that "small businesses employ more than 50% of all workers, provide 51% of private sector output, and are responsible for a disproportionate share of innovations."[18] In the current Congress, Senator Christopher Bond said on the floor of the Senate that

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[18]Sen. Susan Collins, remarks in the Senate, *Congressional Record*, daily edition, vol. 146, Sept. 22, 2000, p. S9033.

"small businesses represent more than 99% of all employers, employ 53% of the private work force, create about 75% of the new jobs in this country, ... contribute 47% of all sales in this country, and ... are responsible for 51% of private gross domestic product."[19] Both statements rely heavily on data reported by the Small Business Administration.

Proponents of current small business tax subsidies also look beyond the direct and immediate economic contributions of small firms to find justification for such measures and their expansion. In particular, they frequently cite the increases in economic efficiency produced by small firms, the dynamic structural changes and important technological innovations introduced by small entrepreneurial firms, the valuable opportunities for social and economic advancement created by small firms for minorities, women, and immigrants, and the difficulties faced by promising small start-up firms in raising capital.

One argument made in support of expanding small business tax subsidies is that small firms can supply certain goods and services more efficiently than large firms. As economist Bo Carlsson has noted, this is true even in industries characterized by large production runs and falling unit costs such as automobiles and steel.[20] In industries such as these, small and large firms specialize in different products or services and often end up interacting more as collaborators than competitors. Carlsson further asserts that the recent rise in outsourcing among large U.S. firms has served to further solidify this division in labor between large and small firms. Among the reputed advantages of small firms in the vast chain of supply is greater flexibility in responding to new market opportunities and competitive threats.

The belief that small firms can serve as powerful agents of dynamic economic change and growth appears to stem in large part from the critical roles played by some small start-up firms in the commercial development of new products and processes in certain industries in recent decades. Two notable findings that have emerged from the growing literature on firm size and technological innovation is that the contribution of small firms to innovation seems to vary by industry, and that their contribution is likely to be most significant in relatively young industries with relatively low levels of concentration.[21] The same literature offers some evidence that in certain industries small start-up firms are more adept than large established firms at identifying promising markets and applications for new technologies and moving quickly to exploit these opportunities. During the 1980s and 1990s, several dramatic illustrations of this pattern emerged: small start-up firms pioneered many key innovations in biotechnology, microelectronics, computer software, and electronic

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[19]Sen. Christopher Bond, remarks in the Senate, *Congressional Record*, daily edition, vol. 147, Jan. 25, 2001, p. S576.

[20]Bo Carlsson, "Small Business, Entrepreneurship, and Industrial Dynamics," in *Are Small Firms Important? Their Role and Impact*, Zoltan J. Acs, ed. (Boston: Kluwer Academic Publishers, 1999), p. 100.

[21]Joshua Lerner, "Small Business, Innovation, and Public Policy," in *Are Small Firms Important? Their Role and Impact*, p. 160.

commerce.[22] Experiences such as these have convinced some economists that small entrepreneurial firms are a vital source of economic growth. They reason that the growth process entails considerable turmoil in the form of the continuous creation and destruction of jobs and firms. Small entrepreneurial firms, according to this view, are essential vehicles for injecting innovation and competition into this process. Bo Carlsson, an economist at Case Western University, contends that without the "heterogeneity and volatility" provided by small start-up firms, "the economy eventually stagnates or even collapses."[23]

Proponents of small business tax subsidies also cite the many benefits for women, minority groups, immigrants, and the communities where they reside of small business ownership as a justification for the subsidies. They argue that small business is a primary vehicle for them to gain access to the social and economic mainstream of the United States. In addition, they claim that women-, minority-, and immigrant-owned small firms benefit their communities and society at large in ways that go beyond their direct economic contributions. There is evidence that female small business owners in general encourage greater openness in workplace communication and decision-making and are more likely to hire a diverse workforce, put into place desired child-care programs, and pay full benefits to employees than male small business owners, and that families with self-employed women who work out of their homes are more stable than the average family.[24] And in the case of minority and immigrant groups, entrepreneurship has proven to be a significant means of building tight-knit social networks, providing job and skills training, and creating informal capital markets.[25]

Yet another economic argument made in favor of small business tax subsidies is that they ease the difficulties faced by many small business owners and entrepreneurs in gaining access to capital markets. If capital markets were perfect, then every small business investment project offering a rate of return above the cost of capital would obtain funding, regardless of the personal financial position of the owners. But, say proponents of small business tax subsidies, such is not the case. They argue that because of imperfections in capital markets, including a lack of information on the part of investors, many potential and current entrepreneurs are not able to borrow or attract equity capital, and thus are forced to either finance projects out of their own resources and the resources of friends and family members, which may turn out to be insufficient, or abandon the projects altogether. Small business owners facing severe liquidity constraints tend to have a relatively low probability of survival.

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[22]*Ibid.*, p. 160.

[23]Bo Carlsson, "Small Business, Entrepreneurship, and Industrial Dynamics," p. 109.

[24]See Candida Brush and Robert D. Hisrich, "Women-Owned Businesses: Why Do They Matter?," in *Are Small Firms Important? Their Role and Impact*, pp. 111-127.

[25]See John Sibley Butler and Patricia Gene Greene, "Don't Call Me Small: The Contribution of Ethnic Enterprises to the Economic and Social Well-Being of America," in *Are Small Firms Important? Their Role and Impact*, pp. 129-145.

Key Economic Arguments Against the Subsidies

Critics of small business tax subsidies acknowledge the significant role played by small firms in the U.S. economy. Nonetheless, they maintain that these contributions do not necessarily constitute a sound economic rationale for such subsidies. Among public finance economists, a conventional rationale for tax subsidies is the presence of some kind of market failure and the need to remedy it through such subsidies. Market failures can be thought of as economic conditions that prevent the achievement of goals of efficiency, equity, or full employment with low inflation. Foremost among these conditions are a lack of perfect competition, the presence of public goods and positive or negative externalities, the existence of incomplete markets, and imperfect information on the part of consumers.[26] Critics say there is no firm evidence some kind of market failure hinders the formation or growth of small firms. What is more, apart from the presence or absence of market failures, they question the appropriateness or effectiveness of some current tax preferences targeted at small firms.

Equity Concerns.

One major concern of critics of expanding small business tax subsidies is that, for the most part, they have the effect of undercutting the progressivity of the federal individual income tax, which rests on the concept of vertical equity. According to this concept, taxpayers with higher incomes should pay more in income tax than taxpayers with lower incomes. It is thought that individuals – and not firms – ultimately bear the burden of business income taxes and receive the benefits of business tax preferences. While all owners of capital are likely to benefit from small business tax subsidies, a large portion of those benefits probably accrues to small business owners, whose income and wealth tend to be well above average for U.S. households.[27] The benefits effectively reduce the tax burden on small business owners relative to other individuals in the same income classes.

Efficiency Concerns.

Critics also find it difficult to justify small business tax subsidies on efficiency grounds. They reason that, in theory, an economy operates most efficiently when all

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[26]For more information on market failures, see Joseph E. Stiglitz, *Economics of the Public Sector*, 3rd Edition (New York: W.W. Norton & Co., 2000), pp. 76-90.

[27]According to a 1990 study by Charles Brown, James Hamilton, and James Medoff, the average family owning a small business had an income that was 80% greater and wealth that was five times greater than the average family. (See Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small* (Cambridge, MA: Harvard University Press, 1990), pp. 15-17.) More recently, in a study of the wealth and income of U.S. small business owners, George W. Haynes found that, in 1998, the mean income of households with small business owners was $101,563, compared to $43,999 for households with no business owners, and the mean wealth of households with small business owners was $832,514, compared to $171,904 for households with no business owners. (See George W. Haynes, *Wealth and Income: How Did Small Businesses Fare from 1989 to 1998?*, Small Business Administration (Washington: May 16, 2001), pp. 24 and 27.)

capital income is taxed at the same rate. This implies that any tax on a factor of production or output that is not uniform across firms may prevent an economy from operating at optimal efficiency.[28] This also implies that taxes should not distort a firm's choice of inputs or its investment or production decisions. Critics maintain that optimal efficiency can be achieved only if the tax code does not favor small firms over large firms or unincorporated firms over incorporated firms, or interfere with the natural growth and evolution of firms, or encourage firms to reach and remain at a particular asset, employment, or revenue size.[29]

Critics also challenge the claim made by proponents of expanding small business tax subsidies that there is something special about the economic role of small firms. More specifically, they deny that small firms are demonstrably and consistently superior to large firms in creating jobs and developing new technologies.

The U.S. Small Business Administration reports that small firms created between half and three-quarters of all new jobs from 1990 to 1997, depending on how the employment size of a small firm is defined.[30] Critics maintain, however, that for a variety of reasons these data do not necessarily prove that small firms are endowed with a greater job-creating prowess than large firms. To begin with, they say that the data raise more questions than they answer, including what it means to be small, when to measure a firm's size, is gross or net job creation a better indicator of job-creating prowess, and how long a job should last before it can be counted as created. In addition, critics point to what they view as a wealth of evidence that small firms are not demonstrably and consistently better at creating jobs than large firms.

First, there appears to be considerable variation over time in the share of new jobs created by small firms: David Birch and James Medoff have estimated that the share of total new jobs generated by firms employing 100 or fewer workers has varied from about 40% to 140%, depending on the stage of the business cycle.[31] Second, most jobs created by small firms are created by new firms, which typically start out small in employment size; and many of these jobs turn out to be short-lived because most new firms fail within their first few years.[32] Third, few firms accounted for most small business job creation between the late 1980s and early 1990s – Birch and Medoff have labeled these firms "gazelles" – and these firms went swiftly from small to large, and, at times, from large back to small, suggesting that their job-creating

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[28]Stiglitz, *Economics of the Public Sector*, pp. 567-569.

[29]Douglas Holtz-Eakin, "Should Small Businesses be Tax-Favored?," *National Tax Journal*, vol. 48, no. 3, Sept. 1995, p. 390.

[30]U.S. Small Business Administration, Office of Advocacy, *Small Business FAQ*, (Washington: Dec. 2000).

[31]David Birch and James Medoff, "Gazelles," in *Labor Markets, Employment Policy, and Job Creation*, Lewis C. Solomon and Alec R. Levenson, eds. (Boulder, CO: Westview Press, 1994), p. 162.

[32]*Ibid.*, p. 8.

ability was unstable at best.[33] And during the 1970s and 1980s, large firms and plants dominated job creation and destruction in the manufacturing sector, and there was no strong, systematic relationship between firm size and net job growth rates in the sector in that period.[34]

Critics also contend that even if it were true that small firms consistently create more jobs than large firms, there is no reason to think that government support for small business would lead to faster employment growth over time. Economic analysis indicates that the economy generates jobs through the natural processes of growth and structural change, regardless of the size distribution of firms. From this perspective, the level of national employment is determined by a mix of factors that would overwhelm the employment effects of any government subsidies for small business. The key factors are fiscal and monetary policy, overall consumption and investment, and the difference between U.S. exports and imports.

Research and development (R&D) is the lifeblood of technological innovation, which, in turn, serves as the primary engine of long-term economic growth. Economists generally agree that without government support, private investment in R&D would fall short of the socially optimal amount. Firms are likely to invest too little in R&D for two reasons. One is that they cannot capture all the returns to R&D investment, mainly because other firms use and extend the results of research in spite of available intellectual property protections. A second reason is that some firms lack access to sufficient capital to invest in R&D because they are unwilling or unable to provide investors with enough information to evaluate the potential returns on planned R&D investments.[35] This systematic underinvestment in R&D represents a market failure in that too few resources are allocated to R&D relative to its potential economic benefits. To remedy this problem, many economists advocate government policies aimed at boosting private-sector R&D investment.

Critics of small business tax subsidies maintain that it is far from clear that this support should be targeted at small firms. They point to evidence that suggests both small and large firms are responsible for the innovations that propel the process of economic growth and structural change, and that it is very difficult to disentangle the contributions of each group. Data reported by the National Science Foundation (NSF) indicate that larger firms perform the vast share of business R&D: from 1992 to 1997, companies with fewer than 500 employees contributed 14% of total business R&D spending, on average, whereas companies with 10,000 or more employees were responsible for 59% of this spending, on average.[36] Nonetheless, there is reason to think that small firms and large firms each appear to have advantages as agents of

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[33]Birch and Medoff, "Gazelles," pp. 162-164.

[34]Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), pp. 169-170.

[35]Scott J. Wallsten, "Rethinking the Small Business Innovation Research Program," in *Investing in Innovation: Creating a Research and Innovation Policy That Works*, Lewis M. Branscomb and James H. Keller, eds. (Cambridge, MA: MIT Press, 1998), p. 197.

[36]National Science Board, *Science & Engineering Indicators – 2000*, Vol. 1 (Arlington, VA: 2000), appendix table 2-54, pp. A-97 and A-98.

technological innovation.[37] In addition, numerous studies have been done of the effects of firm size and market structure on innovation.[38] On the whole, they suggested that no firm size was ideal for generating new and successful commercial technologies, and that in some industries small firms were more innovative, but in other industries large firms had an edge.

Other Concerns.

Questions about suitability and effectiveness arise in connection with some of the principal arguments made in favor of small business tax subsidies. For example, some argue that small firms should be subsidized in order to prevent the development of monopoly power by large firms. But critics claim that it is far from clear that the best way to achieve such a policy goal is to offer tax subsidies to small firms. They point out that only a very small share of small start-up firms survive and grow to the point that they pose a serious competitive threat to large entrenched firms, and that antitrust law is likely to be a more effective tool than small business tax subsidies for thwarting the rise of monopoly power and other anti-competitive business practices.

Similarly, proponents of expanding small business tax subsidies claim that small firms create a disproportionate share of new jobs. But critics respond that if the aim of public policy is to stimulate employment growth, then it appears to make little sense to offer small firms tax subsidies that lower the cost of capital, such as the current expensing allowance. Such subsidies have the effect of lowering the cost of capital relative to labor, thereby encouraging small firms to substitute capital for labor.

Moreover, critics argue that many small business tax subsidies impose an implicit or a hidden tax on business growth. This tax has been described as the notch problem, and it stems from the design of tax preferences targeted at small firms. Under the typical small business tax subsidy, firms lose the tax benefit when their employment, assets, or receipts surpass a certain statutory limit. Such a design may create a powerful disincentive to produce or invest above that limit. The expensing allowance under IRC section 179 offers an illustration. As a firm raises its investment in assets that qualify for the allowance beyond $200,000, the amount that may be expensed is reduced dollar for dollar, ultimately to zero. In effect, this phaseout rule gives firms an incentive to invest no more than $200,000 by substantially increasing their cost of capital in the phaseout range. Jane Gravelle of CRS has estimated that the marginal effective tax rate on investment in equipment is 36% in this range, compared with rates of zero on each dollar of investment up to $200,000 and 22%

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[37]On the one hand, small firms may have a greater potential than large firms to create or dominate a new industry through R&D and may be more flexible than large firms in the pursuit of promising R&D projects. On the other hand, large firms can more easily cover the substantial sunken costs involved in conducting R&D and are more likely to capture a large share of the returns to R&D investments through marketing campaigns, the protection of intellectual property rights, and the creation of regional, national, and international distribution and service and repair networks. See Wallsten, "Rethinking the Small Business Innovation Research Program," p. 197.

[38]F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3rd edition (Boston: Houghton Mifflin Co., 1990), pp. 651-657.

on each dollar of investment beyond $220,000; this estimate assumes a corporate tax rate of 28% and a rate of inflation of 3%. Economist Douglas Holtz-Eakin has concluded that the phaseout rule for the expensing allowance effectively raises a firm's cost of capital at a time when its growth is boosting its capital needs.[39]

Conclusions

There is no question that small firms make important contributions to the performance and growth of the U.S. economy. Available evidence indicates that, depending on how a small firm is defined, they account for a majority of private-sector jobs and private-sector output, commercialize many technological innovations, and serve as agents of renewal and structural change in a variety of industries.

These contributions explain part of the widespread support inside and outside Congress for government policies to assist small business. One prominent manifestation of this consensus is the preferential tax treatment that small firms receive. The combined revenue cost of current federal small business tax subsidies, excluding the tax treatment of passthrough entities, probably exceeds $6.0 billion in FY 2001. A variety of initiatives to expand these subsidies are attracting considerable attention in the 107th Congress.

Conventional economic analysis suggests that it is difficult to justify an expansion of small business tax subsidies on equity or efficiency grounds. Small business tax preferences reduce the tax burden on owners of small firms, diluting the progressivity of the federal individual income tax system. In addition, under current market conditions, it appears that there would be no clear efficiency gains from further subsidizing small firms through the tax code. Economic theory holds that the efficiency losses caused by income taxes are minimized when taxes do not distort the production arrangements within firms and all returns to capital are taxed at the same rate. And what is known about the economic activities of small firms does not appear to support the view that their formation and growth are hindered by market failures that would warrant targeted government support.

This is not to imply, however, that government support for small firms is never justified on economic grounds. There is persuasive evidence that small entrepreneurial firms play a critical role in the production process, economic growth, and structural change. Tax preferences aimed at simplifying tax accounting and compliance for small firms would presumably have desirable efficiency effects. In addition, the appearance of a market failure that hampers the formation and growth of small firms would present a cogent economic rationale for government intervention. A case in point would be capital market imperfections that impede the entry of new small entrepreneurial firms or greatly diminish their chances of survival. Such a market failure could be corrected through policy measures that increase the supply of capital to small start-up firms without substantially distorting the allocation of capital in the economy at large. Tax subsidies might be one such measure, but to be effective, they would need to address the key factors behind the capital market

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[39]Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," p. 393.

imperfections. A continuing challenge for policymakers is to identify market failures that disproportionately harm small firms and devise appropriate policy responses.

The discussion presented here also underscores the need for a robust model of the formation of small firms and their contributions to the economy. As it now stands, much uncertainty surrounds debate on this issue. Holtz-Eakin has noted that the development and empirical testing of such a model would help to determine whether any market failures are linked to the formation and growth of small firms and, if so, to identify the factors that shape these failures and might be correctable through policy intervention.[40]

[40] *Ibid.*, p. 393.